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THE MAGAZINE FOR GROWING COMPANIES

FEB. 1988
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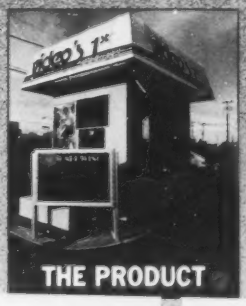
INSIDE JOB
Guarding Against Employee Theft
See Page 91

ANATOMY OF A START-UP



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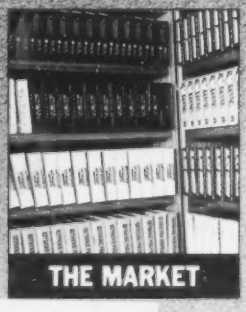
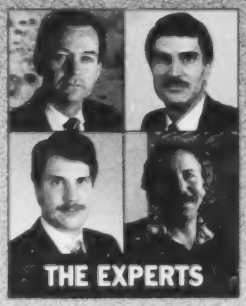


THE MARKET

Monthly Average ($)	Yearly Total ($)
$10,260	$123,117
1,100	13,200
150	1,800
100	1,200
11,610	139,317
3,300	39,600
93	1,116

THE FINANCIALS



THE EXPERTS

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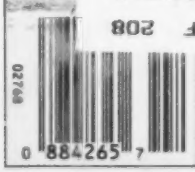

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Worst-Laid Plans

When too many people are bullish, holds one Wall Street bromide, the stock market is headed for a fall. If so, then maybe there was more warning of October's crash than most people think.

DILIP CHAUHAN

LBO specialist Frederick M. Fritz
And what about the bad times?

Starting last spring, observes leveraged buyout specialist Frederick M. Fritz, bullish sentiment had become so pervasive that dealmakers began throwing caution to the winds. "As the market took off, the discipline of recession scenarios crept out of their business plans," notes Fritz, who annually receives some 600 such documents as managing director of BancBoston Capital Inc., the mezzanine-investment arm of Bank of Boston.

"Before that trend set in, a business plan tended to be discounted or discredited if it didn't include a recession scenario as a basic element of conservatism."

Now that Black Monday has sobered LBO packagers along with everyone else, investors are demanding that entrepreneurs take off their rose-colored glasses and again include pullback scenarios. Because the stock market debacle has brought the inevitable recessionary business cycle closer, says Fritz, the presentation should portray a modest two-year downturn beginning by mid-1988. Indeed, he adds, it wouldn't hurt to include a second, worst-case, scenario showing how the company would weather an even more severe recession.

And as far as stock-market theory goes, the gloomier your worst case the better: there's also a saying that when too many people are *bearish*, stocks are heading for a rise. —*Robert A. Mamis*

Sunstroke

Winning the Pentax World Solar Challenge proved a bit of a problem for our boys from John Paul Mitchell Systems Inc. (see "Are We Having Fun Yet?" October 1987). Like the rest of the 25-car field, they were done in Down Under by General Motors Corp.'s Sunraycer entry, an estimated $8-million vehicle that finished nearly three days (and about three years, technologically speaking) ahead of its nearest rival. Still, their enthusiasm remains unflagging.

COURTESY OF GM CORP.

DILIP CHAUHAN

GM's Sunraycer (top); the Mana La
'A taste of things to come.'

"We ran neck and neck with GM for the first six hours," reports John Paul Jones De Joria, chief executive of John Paul Mitchell Systems. "But our car was specifically designed to maximize both wind power and solar power, and the winds forecast for the duration of the race died after day one. We had to run at much lower speeds to conserve battery charge. Then, when the winds returned, the rains came too. Weatherwise, it was a disaster."

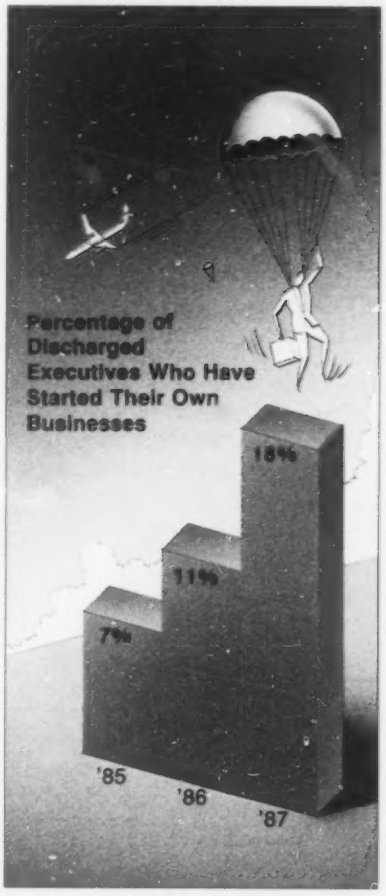
Their car, the Mana La, nevertheless negotiated course speeds of 70 miles per hour and more, and the company hopes to sponsor a domestic competition this spring. Next on the John Paul Mitchell Systems drawing board: a solar street machine for 1988.

"We will stay on top of this technology," vows De Joria, despite the less-than-victorious Australian run. "This race was just a taste of things to come."

—*Joseph P. Kahn*

Fired Up

More than 1 in 6 discharged managers are starting their own businesses now, compared with only 1 in 14 as recently as 1985, claims a recent survey by Challenger, Gray & Christmas Inc., a Chicago-based international outplacement firm. James E. Challenger, the company's president, blames at least some of the rise on corporate programs designed to promote entrepreneurial attitudes among employees. The experience of feeling that a particular job function, responsibility, or department is all theirs, he says, "has given many people the realization that they can run a company."



DALE GLASGOW

What else provides the entrepreneurial push? Shock, says Challenger. Before dismissal, most executives still believe they are with a "forever company," he says. The emotional shock of finding otherwise is so deep, and breeds such insecurity and instability, that many managers turn to entrepreneurship in order to avoid being fired again.

RFD INC.

Where to go when you want to start a business in a remote location

BY DAVID L. BIRCH

Are you tired of the rat race? Hankering for the pastoral? Ever consider tossing in your urban job and heading for some remote locale to start up your own company and lead a simpler life? Perhaps you have in mind a summer place you once lived in or a resort area you've visited. Or perhaps there's a place you've only dreamed about. Whatever. Maybe this column can help.

With modern telecommunications facilities, far-reaching parcel delivery services, an almost-completed interstate highway system, and a U.S. Post Office that is willing to expand its services if you demonstrate a need for them, the possibilities for growing a successful company in the boondocks are quite real. L. L. Bean, in Freeport, Maine, and Lands' End, in Dodgeville, Wis., are two examples that come to many people's minds. But they represent just one specific type of business (mail order) that flourishes in remote places. Think about all the magazines published within a few miles of Peterborough, N.H. (currently there are more than two dozen), or the numerous free-lance consultants who offer their services around the world. Or consider the countless merchants and innkeepers cashing in on a travel boom being fueled by mobile businesspeople and vacationers alike.

At Cognetics, we decided to hang some real numbers on the company-building activity of those who *have* "gotten away from it all" (or who were never near it all in the first place). To begin, we defined remoteness to mean not just rural, but to be any location at least 60 miles away from the nearest metropolitan area. It turns out there are 53 such areas in the United States, distributed across all regions of the country—from Vermont to Georgia to Texas to northern California. And those places, from 1978 to 1987, gave birth to more than 281,000 businesses.

We know that starting a company is tough anywhere. Last month's column showed that even if you could pick any kind of enterprise to open, none would offer ease of entry *and* security *and* growth. Starting in a remote place is—despite technology's capacity to shrink distances—even tougher. You won't find all the support typically found in a larger metropolitan area; no diversity of accountants, bankers, travel agents, copy shops, computer repair services, and so forth.

Remote start-ups and success stories thus tend to be a little different from the mix found in metropolitan America. Generally, they fall into four groups, tending to be businesses that: 1) satisfy fundamental needs, 2) revolve around natural resources, 3) are needed because of an area's remoteness, or 4) would be practical no matter how remotely situated.

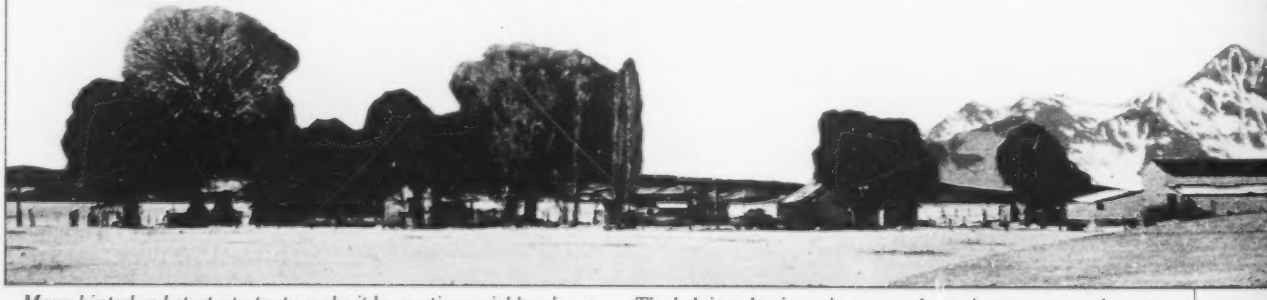
Everyone has to eat, get haircuts, and have cars fixed. People start businesses to

1 BUSINESSES MOST FREQUENTLY STARTED IN REMOTE PLACES

Rank	Type of industry	Survival rank	Growth rank
1	Misc. business services	91	48
2	Eating & drinking places	123	78
3	Misc. shopping goods	119	129
4	Automotive repair shops	63	123
5	Misc. repair shops	52	108
6	Grocery stores	71	77
7	Misc. retail stores	87	116
8	Residential construction	104	100
9	Women's clothing stores	154	112
10	Retail furniture & furnishings	142	105

2 BUSINESSES MOST LIKELY TO SURVIVE IN REMOTE PLACES

Rank	Type of industry	Start-up rank	Growth rank
1	Veterinary services	95	137
2	Legal services	103	100
3	Funeral services	105	126
4	Dentists' offices	153	143
5	Public warehousing	129	64
6	Cash grain crops	112	150
7	Fuel & ice retailers	136	97
8	Hotels & motels	11	72
9	Commercial savings banks	88	1
10	Bowling & billiards places	67	123



NIGEL HOLMES

Many hinterland start-ups try to make it by meeting neighbors' basic needs. (Total field for rankings is 158 businesses.)

The lodgings business is among the easiest to enter and most likely to survive, but hotels and motels don't grow much.

meet these needs in remote places as often as they do in metropolitan areas.

Many remote locations offer great natural resources—farmland, mines, national forests, lakes, oceans—and a particular set of businesses springs up in response: agricultural supply stores, tourist facilities, oil-drilling suppliers, boat builders.

Remoteness *encourages* certain kinds of businesses, such as trucking, telecommunications, air travel, and warehousing. More important, though, it also supports a set of businesses for which distance makes no difference—mail order, for instance, or specialty manufacturing (Ben & Jerry's ice cream, wooden toys).

Figure 1 lists the 10 (out of a field of 158) most commonly started businesses in remote areas from 1982 to 1987. Virtually all of the top-ranked businesses fall into one or more of the four groups just described. Most fit the first category—fundamental needs. But consulting (in miscellaneous business services) and mail order (in miscellaneous shopping goods) are right up there at the top. Slightly farther down on the list are tourist facilities, trucking, oil and gas field services, and computer and data-processing services—each representing one or another of the general classes of businesses that often tend to crop up away from it all.

Of course, as we learned last month, frequency and ease of entry do not guarantee success. For each of the 158 types of businesses with 100 or more start-ups from 1978 to 1982, we computed their odds of survival and their odds of achieving significant growth. Figure 1 shows how the most frequently started businesses fare by these measures (on a scale of 1 to 158). It's not too encouraging.

So let's look at the survival rankings, instead. After all, you didn't head for the hills just to be like everyone else. You went there to relax a little more, and worry a little less about getting by. Unfortunately, as figure 2 demonstrates, the businesses most likely to survive are tough to get into, or may not be your natural first choice. Not everyone, for example, dreams of becoming a funeral director. And it isn't easy to become a veterinarian, lawyer, or dentist—as their start-up frequency rankings suggest. Hotels and motels, on the other hand, look like a pretty good bet for getting started and staying alive—but not for growing very much.

If it is growth you're after, then make something. Figure 3 shows that 8 of the 10 fastest-growing kinds of businesses are in manufacturing. Manufacturing facilities are not all that easy to start, however—they require relatively large amounts of capital. But several types survive quite well once they get going.

Now for the brass-ring question: are there any kinds of remotely based businesses that look good by all three measures? The answer, sadly, is not many. Only 3 rank in the top 50 for frequency of entry, survival, and growth. They are: manufacturing of miscellaneous machinery, electrical contracting, and petroleum wholesaling.

If none of these is your thing, you are going to have to choose among ease of entry, security, and growth.

Would you like some entrepreneurial companionship in your bucolic new home? The remote places that gave birth to the most new businesses between 1982 and 1987 are as diverse as rural Georgia and south central Wisconsin (see figure 4). If growth is your goal, then the state of Vermont—at least statistically—offers the best environment in which to grow a new business.

It's safe to say, I think, that remoteness isn't nearly the disadvantage it was as recently as 10 or 15 years ago. It still makes company building tougher, but literally hundreds of thousands of people *are* starting successful businesses in out-of-the-way places. It can be done. □

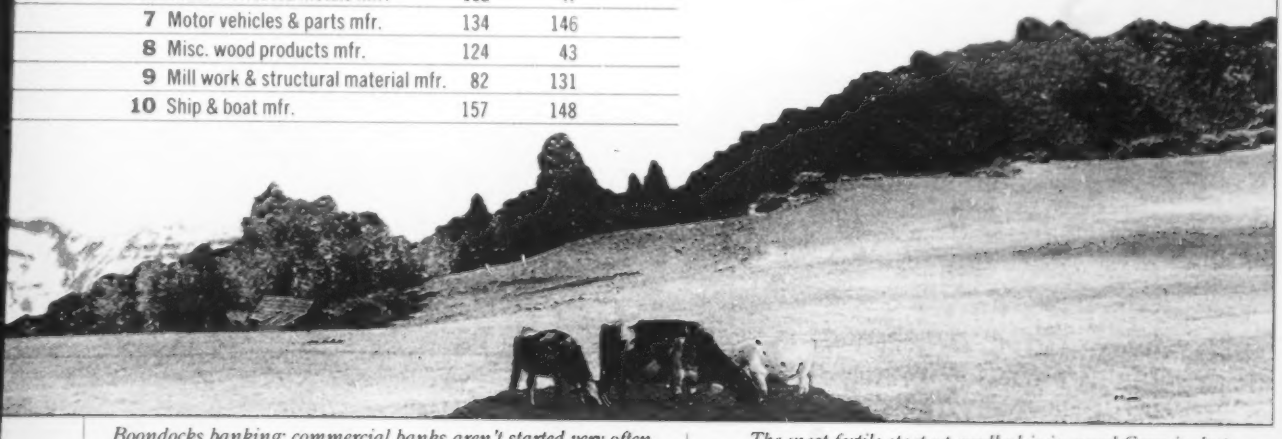
David L. Birch is president of Cognetics Inc. and director of MIT's Program on Neighborhood and Regional Change.

3 BUSINESSES MOST LIKELY TO GROW SIGNIFICANTLY IN REMOTE PLACES

Rank	Type of industry	Start-up rank	Survival rank
1	Commercial savings banks	88	9
2	Misc. plastic products mfr.	94	127
3	Floor coverings mfr.	146	152
4	Metalworking machinery mfr.	111	11
5	Nursing & personal care facilities	85	14
6	Misc. fabricated metals mfr.	152	47
7	Motor vehicles & parts mfr.	134	146
8	Misc. wood products mfr.	124	43
9	Mill work & structural material mfr.	82	131
10	Ship & boat mfr.	157	148

4 RURAL START-UP HOT SPOTS

	Remote places with highest start-up frequency	Remote places where start-ups have greatest chance of growth
1	Rural Georgia	Vermont
2	Northwestern rural Ohio	North Georgia mountains
3	South central Wisconsin	Eastern Maryland
4	North central Texas	Rural Maine
5	Southern rural Missouri	Alaska



Boondocks banking: commercial banks aren't started very often, but they usually survive—and they almost always grow.

The most fertile start-up seedbed is in rural Georgia, but Vermont is where new businesses are most likely to grow.

TAXES

An Owner's Manual

BY IRVING L. BLACKMAN

Costs of business searches

When you're in the market for a new business, you can spend thousands of dollars running ads, traveling around the country to look at companies, and hiring auditors to evaluate several prospects. Yet if your search is unsuccessful, the Internal Revenue Service says that you cannot deduct expenses for a general search or a preliminary investigation.

Say that you do find the company of your dreams, and you incur further costs, such as legal fees—and then the deal falls through. You can deduct the legal and other expenses that are specific to the negotiation, but you still get no deduction for those general search expenses.

But there is a way to assure a 100% deduction for all expenses. The answer is to incorporate. Then buy stock from your new corporation equal to the amount of the anticipated search; have the corporation, instead of you personally, incur the expenses of looking for the new business. If you find what you want and buy the operating assets, you have a corporation set up and ready to go. If you don't find what you want, you will be able to get a personal deduction for the expenses incurred by the corporation. How? Liquidate the corporation. A little-known section of the Internal Revenue Code, Section 1244, allows you an ordinary deduction, rather than a capital loss, on your stock loss in amounts up to $50,000 for a single taxpayer or $100,000 for a husband and wife filing a joint return. (For another use of 1244 stock, see "Attracting Capital," below.) □

Attracting capital

If you're looking for ways to entice friends and relatives to help capitalize your small company, you should know about Section 1244 of the Internal Revenue Code. The idea behind the legislation is to give a kind of investment insurance to anyone investing in a small, incorporated business.

The way it works is this: an investor who buys Section 1244 stock gets the best of all tax breaks: capital gains, which can be offset against capital losses if he sells the stock at a profit; and ordinary loss treatment if he sells at a loss or if the business fails and the stock becomes worthless. Ordinary losses are limited to $50,000 for single taxpayers and $100,000 for married taxpayers filing a joint return. But compare those numbers with the tax law's capital losses, which can be deducted only at the rate of $3,000 a year.

If you're incorporated, you can issue Section 1244 stock, provided the following four requirements are met at the time the stock is issued:

□ Your company has received 50% of its gross receipts from operations—as opposed to passive income such as interest and dividends—for as long as it has been in business over the past five years.

□ You issue the stock for cash or property, not stock or securities.

□ Your company has received $1 million or less for its stock, including the Section 1244 stock you're planning to sell.

□ The stock is newly issued.

You can issue and sell Section 1244 stock to yourself as well as to outside investors. (For another use of 1244 stock, see "Costs of Business Searches," above.) □

CORPORATE TAX RETURNS AUDITED IN 1986 (BY SIZE OF ASSETS)

Balance sheet assets	1985 returns filed	Number audited	Percent audited
$0–50,000	803,200	5,988	0.75%
50,000–250,000	865,400	12,733	1.47
250,000–1 million	507,100	7,922	1.56
1 million–5 million	198,700	9,349	4.71
5 million–10 million	28,400	3,639	12.81
10 million–50 million	31,000	7,400	23.87
50 million and more	15,700	9,892	63.00

Source: *Internal Revenue Service Highlights of 1986*, U.S. Government Printing Office, 1987.

If you play by the percentages, the smaller your assets, the lower your chances of getting audited by the Internal Revenue Service. But don't overlook the numbers.

Stock transfers

There are any number of ways to transfer stock ownership, but a stock bonus has particularly interesting tax benefits. It's a technique you can use to shift shares of stock from you to your successor—an employed relative, say, or a key employee.

As an example, let's assume that you eventually plan to turn your business over to your daughter, who now works with you. So you give her a bonus in shares of stock—but not so much as to cause an "unreasonable" compensation problem with the IRS.

These are the tax consequences of the tax bonus:

□ Your employed daughter must pay income tax on the fair market value of the stock she receives.

□ The corporation can deduct the fair market value of the stock it gives as compensation.

□ The corporation does not pay income tax on the benefit (the tax deduction) it receives.

This combination is advantageous all around. The corporation gets a full tax deduction for the fair market value of the stock. You've decreased your ownership, and your daughter's share has increased. It is as if you had sold her some of your shares—except the stock bonus is tax free to you. □

A quick loan

Certain restrictions go along with an individual retirement account, and one is that you can't borrow from it. You can't even pledge it as collateral for a loan. In either case the amount would be included in your current income, and if you're under 59½ years old, you'd have to pay penalties as well.

But if you need money for only a short period, you can in effect borrow from your IRA.

The law allows you to remove money without triggering current income or penalties if you roll the exact amount removed into another IRA within 60 days. And there you have it: interest-free use of the funds for a short-term need. Still, you can't make a habit of this: you can use the 60-day maneuver only once a year. □

Irving L. Blackman, specializing in closely held businesses at Chicago-based Blackman Kallick Bartelstein, certified public accountants, speaks and writes on tax issues.